ASSET ADMINISTRATION

Management of property for others is the principal function of a fiduciary. Fiduciary law as well as state statues largely deal with this aspect of a fiduciary's business. In the investment of trust funds the bank is under a duty, as discussed in Section 227 of the Restatement of the Law of Trust 2d, to conform to the terms of the trust or in the absence of provisions in the terms of the trust to conform to applicable statutes. In the absence of either the trust provisions or statutes, the trustee is to make such investments as a "prudent man" would make of his own property keeping in mind the preservation of the estate and the amount and regularity of income. The department's investment policies and practices are of major importance in the trust examination.

A. TRUST INVESTMENT POLICIES

The ultimate responsibility for establishing overall investment policy remains with the board of directors or a trust committee appointed by the board. The basis of any investment policy should be sound fiduciary principles, including the preservation of capital, diversification, and a reasonable rate of return. The "Prudent Man Rule", which has been adopted by statutes and/or courts of many states, governs trust investments from a legal standpoint. An investment policy should therefore be formulated to comply with this role.

Many trust departments have a trust investment committee that administers investment policy, although smaller departments may utilize the board of directors or the trust committee for this purpose. The committee reviews and passes on recommendations made by the research division, investment advisory firm or investment officers. Often the committee is charged with the responsibility to review individual account portfolios and determine whether or not assets are invested compliance with the overall investment policy.

Accounts for which the department has investment responsibility should be given an asset review in accordance with the Statement of Principles of Trust Department Management. The initial review should, in most cases, be conducted within 60 days of acceptance and should establish an investment program for the account. Reviews should include individual account reviews, wherein the merits of securities comprising the portfolio, the legality and suitability for retention, the current rate of yield on cost basis, and current market value are considered. Asset holdings should be reviewed in the aggregate for each obligor, taking into consideration financial and other information relevant to the industry and the company's standing within that industry. Assets such as real estate and mortgages should also be reviewed on a similar basis.

The overall investment policy should be broad enough to carry out the purposes of a variety of trusts. For example, individual trusts under will or agreement are usually established for the purpose of providing income to the income beneficiary(s) and leaving the principal (corpus) to the remainderman at termination of the trust. By contrast, employee benefit trusts need to generate sufficient growth and income to provide the promised retirement benefits to participants and their beneficiaries.

Some states have laws limiting the types of investments permissible for an account or the proportion of an account that can be invested in common stocks. On rare occasions, they even provide a legal list of securities that can be purchased by trustees. Investment policies, therefore, should also comply with applicable laws and statutes.

B. TYPES OF INVESTMENTS

Various investment vehicles are available for the investment of trust funds. The types of investment which might be found in trust departments are discussed below, along with applicable regulations, examination procedures, and other matters relating to investments.

<u>Marketable Securities</u> - Marketable securities (stocks, bonds, debentures, etc.) generally comprise a substantial portion of a trust department's assets. Investment policies and procedures should be formulated and approved by the board of directors. Investment decisions for accounts where the bank invested with discretion should be based on research performed in house, acquired from outside sources, or based on ratings by acceptable rating services, following consideration of relevant factors pertaining to the type of investment and the purpose and investment objectives of the account.

In addition to reviewing investment policies and procedures relative to research, the examiner should ascertain whether or not the bank has a policy of establishing lists of securities approved for purchase, retention or sale. If such lists are maintained, bank policies should specify the person(s) having authority to make additions or deletions. The lists should be reviewed periodically to determine the current appropriateness of the investments. Additionally, the bank should establish procedures for monitoring purchases and sales in order to ensure compliance with the approved lists.

Securities and transactions in securities are largely governed by Federal law. The following discussion addresses some important aspects of securities regulations.

Restricted securities are nonregistered securities obtained in a transaction not involving a public offering. Normally a trust department acquires such securities in kind rather than by purchase. To sell such securities the trust department must comply with the requirements of Regulation 230.144 (Rule 144) of the Securities and Exchange Commission (SEC) pursuant to the Securities Act of 1933. In general, Rule 144 provides that for the securities to be sold without a formal registration; the securities must have been beneficially owned for at least two years, the amount sold in any three-month period not exceed the greater of 1% of the outstanding securities of the class being sold or the average weekly trading volume for the class during the four-week period preceding the sale, and the securities must be sold either in a broker's transaction or in transactions directly with a market maker. In addition, adequate information regarding the issuer must be available to the public and a Notice of Sale (Form 144) must be filed with the SEC. No report to the SEC is required if less than 500 shares are sold in any three-month period and the sale price does not exceed $10,000. Under certain circumstances the volume limitations may be disregarded after a holding period of either three or four years. The three-year period applies if the securities to be sold are listed on a national securities exchange or quoted on NASDAQ. The four-year period applies if the securities are not exchange listed or NASDAQ quoted, but the issuer files periodic reports under Section 13 or Section 15(d) of the Securities Act of 1934.

For accounts in which the bank has investment discretion, Section 13(d)(1) of the Securities Exchange Act of 1934 requires that holdings of certain equity securities which exceed 5% of the total number of shares outstanding of the issuing corporation be reported to the SEC, the issuer and appropriate exchanges within ten days of acquisition. This requirement applies to any equity security of a class which is registered pursuant to Section 12 of the Act, certain equity securities of insurance companies, and equity securities issued by a closed-end investment company registered under the Investment Company Act of 1940. If the bank does not maintain a list of equity securities exceeding 5%, the examiner should request the bank to do so. A more thorough discussion of this is found in subsection C of the Section.

Trust departments which exercise investment discretion with respect to accounts holding an aggregate fair market value of at least $100,000,000 in exchange traded or NASDAQ quoted equity securities are required by Regulation 240.13f-1 (Rule 13f-1) issued by the Securities and Exchange Commission pursuant to the Securities Act of 1934 to file quarterly reports.

The examiner should ascertain that all the aforementioned reports have been properly prepared and submitted.

Notes and Mortgages - Notes and mortgages can be acquired in many ways including acceptance with a new account, sale of real estate from a trust account in return for a mortgage, and the outright purchase of notes and mortgages. There are three basic types of notes and mortgages; unsecured loans, loans secured by real estate, and loans secured by other than real estate.

The only assurance for the lender with respect to an unsecured note is the creditworthiness and ability of the borrower to repay. Unsecured loans are therefore rarely seen in trust departments as they may be considered imprudent.

Real estate loans are proper fiduciary investments where appropriate for the account involved, provided there is adequate security. A trust department should not purchase loans or participations therein from the commercial department of the bank. Nevertheless, the trust department may participate in the origination of a loan, using the expertise of commercial loan officers to finalize the arrangement. It is ordinarily improper to invest in second or junior mortgages unless the same account holds all senior mortgages. Although a sufficient margin of safety exists, a junior lienholder cannot control the situation; the senior encumbrance may be foreclosed and the junior encumbrance eliminated.

All mortgages should be held in some form of trust capacity unless otherwise permitted by the terms of the trust instrument or state statute. In addition, the mortgage should be accompanied by documentation necessary to establish priority of lien, an appraisal, and evidence that appropriate insurance payable to the corporate fiduciary is in force. A prudent ratio of loan to appraised value should be maintained. Adequate credit information should be obtained to substantiate the borrower's ability to repay. Ticklers or checklists may be established by the bank to monitor payment of taxes, assessments and insurance.

For notes secured by other than real estate, the bank should have a perfected security interest in the collateral. Each state has requirements in this regard and many have adopted provisions of the Uniform Commercial Code. For negotiable property, the key to security is physical possession. In the case of automobiles and some machinery, title is the key to perfecting security.

Procedures need be established to handle delinquent loans and there should be a follow-up program for collection. Delinquencies should be reported on a regular basis to the board of directors, its trust committee, or other appropriate committee.

Notes and mortgages like other investments should be analyzed periodically to determine the desirability for retention. The collateral should be revalued periodically to ensure it continues to exceed the balance due. If the security is real estate, it should be reappraised and inspected periodically to ensure that it is being adequately maintained.

Private placements are privately negotiated loans between the trust department and a potential borrower. Since the loan is privately negotiated, the instrument may be highly illiquid. Therefore, the highest degree of confidence should be placed in the financial strength of the borrower. Private placements like other banking activities should be subject to adequate safeguards and policy considerations. Special care should be exercised to ensure that self-serving practices or conflicts of interest do not develop. Policy constraints should prohibit placing private issues with funds the bank manages in a fiduciary capacity, especially when the issuer is a bank loan customer. A serious conflict of interest could result if the bank were to use or permit the use of proceeds from a placement to reduce criticized loans or accommodate borrowers who are not creditworthy.

<u>Real Estate and Mineral Interests</u> - Real estate is generally acquired as a trust account asset resulting from the personal activities of the grantor or testator and can include such types as personal residences, residential income properties, commercial properties, unimproved lots and acreage. The real estate may be added to the trust as part of an overall estate plan or passed to the executor under the will. In some instances real estate may be added to trust accounts as an investment vehicle, however, in the absence of special circumstances or specific authority granted in the trust instrument, a bank should be cautious of investing trust funds in real estate. Under common law, the purchase of property for resale is not considered prudent unless specific provision has been made in the terms of the trust.

In making decisions relative to the purchase or retention of real estate, the bank should first determine whether such investments are authorized in the instrument. Other factors to be considered include: the types of accounts for which real estate may be appropriate; planned or current use of the property; geographic location, size of the parcel and its future marketability; risks involved in construction or development property and farmland; appraisal by competent appraisers; price comparisons with similar properties; net yield comparing net income to the purchase price; and cash flow and potential appreciation. Decisions to retain real estate should be governed by the requirements of the trust instrument with appropriate consideration given the current yield and ease of marketability once funds are needed to terminally the account or provide for principal withdrawals. Appropriate guidelines should also be in place for selling real estate including appraisals by competent and impartial appraisers. It should be remembered, a trustee has the duty of impartiality in dealing with beneficiaries and capital gains generally accrue to remaindermen.

For trust purposes, realty investments are basically considered speculative where the assumption of risk and the hope of gain are higher than found in other investment vehicles. Real estate of all kinds is burdened with poor liquidity. Raw land generally bears an even higher degree of risk. Although the long-term growth potential and possible tax benefits may be positive factors, the illiquidity of real estate investments has limited their use to large or special purpose accounts (e.g., pension trusts).

The variety of properties requires different degrees of management knowledge and expertise. For example, farms are not handled in the same way as commercial income property. Every property held by the trust department should be reviewed at least annually to determine whether or not the asset meets the needs and objectives of the account and its beneficiaries. When a property is received by the trust department it should be physically inspected as soon as possible to determine its condition, verify leases and renters, and make sure that adequate insurance is in force. In addition, the bank should have a program for reviewing the condition of the real estate and other factors through annual inspections or personal knowledge of the property obtained by bank personnel or agents where inspection is not feasible. In order to ensure that adequate insurance is maintained and to better equip the department in deciding on retention or sale of the property, it should be reappraised periodically. The nature and estimated value of the property should be taken into consideration when deciding between an in-house or outside appraisal. For example, property of nominal value would not require an outside appraisal, whereas, a large shopping center would require an in-depth appraisal by a qualified appraiser. At a minimum, most property should have a current outside appraisal made prior to sale.

All parcels of real estate should appear on the books at some value. The bank should maintain appropriate documents for each parcel of real estate. Instruments or copies of instruments that should be on file are deeds, mortgages (deeds of trust), liens and/or releases, owner's title policy or opinion, leases, contract of sale and closing statements, receipted tax bills, fire and liability insurance policies, contracts for improvements, and instruments conveying interests to the bank.

Procedures should be established to provide for the maintenance of adequate income and expense records covering properties held. Ticklers or other methods should be used to monitor timely payment of insurance premiums, mortgages and real estate taxes. Procedures should also be established for follow-up on delinquent rent.

In cases where property is managed by others, a management agency agreement should establish the agent's duties and responsibilities, frequency of reporting and commission charges. Management contracts or leases of farms should include guidelines pertaining to authority for sale of crops or livestock, payment of operating expenses, basic repairs and maintenance on buildings, fees charged by the bank, etc. In addition, procedures should be established for verifying the amount of farm commodities stored in elevators or warehouses.

Investments in natural resources such as oil, gas and mineral interests, may be found in some trust departments. Such investments require special expertise. Policies for management of these assets should be established. The authority for acquiring and/or retaining these assets should be evidenced by specific language in the governing document or by consent of all interested parties. Holdings of this type should be reviewed regularly in view of performance and appropriateness. Evidence of title such as copies of deeds and title opinions should be maintained. The status of the property, whether leased or unleased and producing or nonproducing, should be determined by the bank immediately upon accepting an account. When properties are placed in trust, the instrument conveying the property to the trustees should be recorded in the county or parish of the state in which the property is located. Copies of any leases should also be maintained. If working interests are involved, the bank should have a copy of the operating agreement. If necessary, adequate property and liability insurance should be obtained. Proper bookkeeping and information systems should be established and include ticklers covering delayed rentals on nonproducing interests, expiration of all leases and royalties, and income and expense records. Appropriate checks should be established to identify omitted or significant changes in regular lease income payments. In order to hold title to mineral interests in another state, the bank may have to qualify to do business as a fiduciary in that state or arrange for an ancillary trustee to be appointed.

Master Notes - A trust department may have one or more master note arrangements. The investment vehicle provides a means whereby various fiduciary accounts may be invested on a short-term basis in a variable amount note of a single borrower. Master notes are a form of collective investment used in place of or in addition to a bank's Short Term Investment Fund (STIF).

Documentation of the borrowing arrangement would include the note evidencing the maximum amount of the loan which may be on a demand basis or have a fixed maturity. Either the note or a separate loan agreement will detail the terms of the credit. The note is payable to the bank or a nominee and may be repayable by the borrower(s) in whole or part at any time. The amount of the loan may be subject to daily fluctuations as increases or decreases are made in the participation. If an account acquires or increases a participation, a buy order is executed; if the account withdraws or reduces a participation, a sell order is executed. Buy and sell orders are combined at the end of the day resulting in an adjustment to the loan which is communicated to the borrower on the following business day and may be accepted or rejected. Interest must be paid monthly on the daily amount of the loan outstanding during the preceding month at the agreed upon rate.

A separate investment control is maintained for each master note. A participant record for each account should be maintained and appropriate checks made by the bank each time the loan balance changes to ensure that participant records reconcile to the amount outstanding. Asset records for each participating account must reflect the investment in the master note.

Broad investment powers in the governing instrument are sufficient authority for such investments. However, investments by accounts for which the bank does not have full investment responsibility must have letters of direction from the parties authorized to direct each purchase or safe. Custodial and agency accounts may invest in master notes if terms of the governing instrument contain no such prohibition.

All master notes should be issued by companies classified as "prime credits", i.e., an issuer rated in one of the two highest rating categories by at least two nationally recognized investment rating organizations. The bank should have full information on the capital, debt structure, and financial condition of the issuer including total amounts borrowed on master notes, total long and short-term borrowings, and the most current financial statement. Additionally, the bank should obtain quarterly certifications that the notes are not subordinated to any other debt of the company, there is no litigation pending or threatened which would affect such notes, and the issuer is not in default on any of its outstanding obligations.

As a guideline, if the total amount of variable or master notes exceeds 10% of the market value of assets held by the trust department, the examiner should question the prudence of such investments. A bank which has notes issued by any one company in excess of 5% of the market value of the department's total assets, should be requested to justify the prudence of such investments. Where a note has both a demand basis and fixed term component, the examiner should comment upon the arrangement when the fixed term is in excess of 50% of the principal amount of the note. As with other investment mediums, the bank should have appropriate written policies and procedures governing the use of master notes including the maximum amount of funds to be extended, requirements regarding submission of current financial information, a provision for periodic credit review and approval of the borrower, and standards requiring borrowing resolutions.

A conflict of interest situation may exist if the commercial department of the bank also has loans outstanding to the master note obligor.

Repurchase Agreements - A repurchase agreement is an acquisition of funds through the sale of securities with a simultaneous agreement (commitment) by the seller to repurchase the securities at a later date. In a typical arrangement, the owner of a U.S. Government or agency security transfers possession of the obligation for a percentage of its market value, but retains ownership and the inherent rights to receive the interest and principal of the obligation. At an agreed upon future date, the owner (seller) repurchases the obligation by remitting the amount borrowed plus interest at prevailing market rates. A repurchase agreement transaction, regardless of the terminology used to identify it, is a secured borrowing by which an owner (seller) leverages existing positions in securities by pledging these holdings against the repurchase lability.

A number of trust departments engage in repurchase agreement transactions (repos) as a temporary investment vehicle for cash balances awaiting permanent investment or distribution. In this context, a trust account becomes the lender of funds to a financial institution or a broker/dealer. Although the trust account acquires an asset, it will generally be identified on the trust department's records as a repo. The repo will be collateralized provided a security interest has been perfected, normally by U.S. Government or agency securities, bear a fixed rate of interest or interest at prevailing market rates unrelated to the coupon rate of the collateral, be payable at a fixed maturity (one day or longer), and may be subject to other terms and conditions.

Repurchase agreements bought from the bank's own commercial department or affiliates, represent loans by trust account(s) to the fiduciary bank and involve a conflict of interest or at least the appearance of self-dealing. The Corporation's Statement of Policy on Retail Repurchase Agreements provides that a bank's trust department should not buy retail repos from the bank's commercial department or its affiliates nor should the bank sell retail repos to its trust accounts. The purchase of obligations of this nature from the bank's commercial department, affiliates of the bank, or other organizations where there exists an interest such as might affect the best judgment of a bank when engaging in the transactions, should not be made unless specifically authorized in the instrument creating the trust relationship, <u>or</u> by court order, <u>or</u> by local law, <u>or</u> unless prior written approval is obtained from all interested parties. If appropriate authorization is contained in the instrument or local law, or obtained from a court or all interested parties, the examiner must review the investment in light of normal investment considerations, e.g., rate of return, appropriate account investment diversification, adequacy of pledged securities (collateral margin), maturities, etc. The bank must pay a competitive rate of interest and the repo investments for trust accounts must be on terms no less favorable than those granted to others purchasing the same types of repos.

If appropriate authorizations for investing in repos of the bank's commercial department or affiliates are not on hand, these transactions are considered a conflict of interest and self-dealing. In such cases, the examiner should fully discuss the matter with management, obtain a commitment to take corrective measures, and detail the situation in the report of examination. Management should be requested to notify the Regional Office when corrective measures have been accomplished.

The Department of Labor in Prohibited Transaction Class Exemption 81-8, dated January 23, 1981. "Short-Term Investments", allows employee benefit plans to acquire repurchase agreements with maturities of one year or less from parties-in-interest. However, the obligor financial institution or its affiliate(s) cannot hold discretionary authority or control over the investment of assets of the plan purchasing its obligation. If the department has purchased own-bank or affiliate repos for discretionary accounts or directed employee benefit plans subject to ERISA prohibited transaction provisions without obtaining proper written direction, the examiner should fully discuss the matter with management and schedule the investment(s) as an apparent violation(s) of ERISA Section 406 (prohibited transactions with a party-in-interest) and/or ERISA Section 404 (fiduciary standards, as self-dealing is a violation of the established fiduciary standards).

Repurchase agreements bought from other financial institutions or broker/dealers may be an acceptable short-term investment provided this type of investment is authorized by the governing instrument and/or state law and is appropriate to the investment needs of an account's beneficiaries. It must be kept in mind that repurchase transactions represent another form of lending. Consequently, considerations normally associated with granting secured credit should be made by the trust department. Repayment or repurchases by the selling institution or broker/dealer is a major consideration and the trust department should satisfy itself that the seller will be able to generate the funds necessary to repurchase the securities on the maturity date of the contract. In assessing the propriety of these transactions, the examiner must determine if the trust department has considered the ability of the seller to meet its commitment to repurchase on the prescribed date and should review the investment in light of normal considerations as outlined above.

Repurchase agreement transactions are considered a form of secured lending. Therefore, the bank should have written policies governing their use as trust investments and a written agreement for each transaction outlining specific provisions pertaining to collateral margins. Acceptable margin, the percentage by which collateral securing the loan exceeds the credit, should be determined by considering the maturity and the historic and anticipated volatility of the securities pledged, and the maturity of the repurchase agreement. Collateral should be priced on a regular basis to assure maintenance of the required margin.

Monies should not be loaned until acceptable types of securities are delivered into the bank's custody or an independent safekeeping agent designated by the bank. In any event, trust department management should not make such investments without having determined that the accounting(s) will have acquired a perfected security interest in the collateral securities. Registered securities should be endorsed in such manner to ensure negotiability and, in other respects, collateral coverage arrangements should be controlled by procedures similar to the safeguards used to control any type of liquid collateral. The examiner should determine whether or not proper procedures have been established for the control of collateral and protection of collateral margins.

As with any investment or lending transaction, written policies and procedures should be adopted by the bank's board of directors to control the activity. Areas to be covered by policy relative to repurchase transactions include; setting a maximum amount of funds to be extended to a single or related firms by any one account and by all accounts in the aggregate, requiring borrowing firms to supply corporate borrowing authorizations, requiring submission of current financial information, and providing periodic credit reviews and approvals by the trust department of the borrowing entities.

<u>Business Interests</u> - The primary types of business interests encountered in a trust department are: (1) stocks or other securities of closely held corporations, i.e., a corporate entity whose stock is not actively traded, (2) partnership interests either general or limited, (3) sole proprietorships, and (4) joint ventures. The administration of business interests is often demanding, time consuming and requires expertise.

Family business interests as trust assets can pose administrative problems to the trust department. One of the greatest in closely-held securities is the limited marketability due to concentrated ownership. The illiquidity of minority interests and lack of investment diversification may cause concern. Where the bank holds a minority interest, it may attempt to ascertain ownership of other interests to effect joint control over the management of the company. The surcharge potential is perhaps the most important concern with fiduciary appointments involving family business interests.

The examiner's purpose in reviewing closely-held securities is to evaluate the institution's treatment of the business interests and ensure that management has the necessary expertise to manage the securities. Due to the surcharge potential, the bank should thoroughly review significant factors prior to accepting an appointment which includes a closely-held business. It may be desirable for the fiduciary to represent the account by having a bank officer serve as an officer or director of the company, if bank policy permits. However, a directorship involves a certain degree of potential liability to the bank and the individual therefore, consideration should be given to obtaining appropriate indemnity insurance.

Occasionally banks are appointed executor or administrator of an estate which includes a proprietorship or a partnership interest. As a general rule such businesses terminate upon the death of the proprietor or partner, but it usually takes considerable time to settle the business. The bank should work closely work estate counsel and others who might be interested in the business, as conveyance of such business property or interests is complicated and may be disruptive to beneficiaries. It is important to determine that the bank limits its liability in administering such property.

Conflict of interest situations may arise when the bank is lending to the business. The bank should approach this area cautiously, seeking outside financing sources first. Additionally, the bank should prohibit its personnel from acquiring an interest, financial or otherwise, in the company other than representing the beneficiaries and the bank.

The examiner should review department policies regarding business interests to determine sufficiency and soundness. The expertise of the bank in administering such interests should be evaluated through a review of board minutes, trust committee minutes, files, and qualifications of personnel. The extent of compliance with laws, instruments and standards of prudence should be determined, the possibility of conflicts of interest ascertained, and potential for liability to the bank assessed.

Options - Some trust departments use exchange-traded put and call options for accounts as a means of increasing trust account revenue. Whether engaging in options transactions is or is not legally permissible for trust accounts depends upon the terms of the instruments governing the trust relationships and the applicable investment laws governing the specific types of accounts. Employee benefit trusts are governed by the Department of Labor's rule of prudence promulgated pursuant to ERISA, whereas other types of accounts are governed by applicable state law.

Because most departments have restricted option writing activity to covered call options, discussion centers on these types of transactions. However, it is recognized that under certain conditions, the writing by a department of put options within clearly defined policy parameters may be an acceptable and appropriate investment strategy for some accounts. Prior to utilization of options as an investment practice, sound policies should be formulated and adopted by the board of directors. The policy statement should deal with the propriety of option writing for different types of fiduciary accounts, define the permissible option strategies that may be employed, define the dollar volume types of options that may be written regarding individual accounts, establish procedures for reporting and approving such transactions, and prescribe control and recordkeeping practices. The policy statement should be reviewed on a regular basis, no less frequently than annually, to ensure that approved positions are appropriate. The trust department should also obtain an opinion from bank counsel as to the legality of these activities.

When a department writes a covered call option on stock held in its trust accounts, it sells to a third party the right (option) to purchase that stock (call) at a specified price until a specific date. Possession of the stock by the trust account (covered) is the final element necessary for a transaction to be identified as a "covered call option".

Receipt of cash (fee) paid by the third party for the option permits an additional return on the stock if the market price remains the same and cushions the potential loss if the market value declines. An element of risk is involved if the market value of the stock rises, in which case the holder of the option may exercise the right to purchase the stock at the previously agreed upon price. In such instances, because of the granting of the option, the trust account may be unable to take full advantage of rises in the market. While the trust account will receive the cash proceeds resulting from the sale, reinvestment of these funds in a rising market will likely result in a reduced yield (income) to the account.

Options guarantee letters or escrow receipts are documents issued by a bank in connection with the writing of covered call options. The documents are designed to be used on behalf of any customer as well as the bank's trust accounts. The document is called an "escrow receipt" when the underlying option transaction is handled through the Options Clearing Corporation, but is called an "option guarantee letter" in other circumstances. The securities which underlie the covered call option are deposited with the bank.

The writer is then permitted to write the call option through a special cash account with a broker rather than through a broker margin account or by other means.

In the document, the bank represents and warrants that specific authorization has been received from the customer to issue the guarantee letter and hold shares of stock pursuant to the terms of the letter and, that it holds and will continue to hold a stated number of shares of a particular stock until the expiration date of the letter or until the call is exercised. If the call is exercised, the bank warrants it will deliver the stock in a timely manner. The expiration date of

the letter is a date certain unless delivery is required and not completed. In that case, the expiration date is extended until completion of delivery of the stock by the bank. The letter also includes a statement that the agreement represents an obligation of the bank generally, rather than an obligation of the bank in any particular capacity or as a fiduciary with respect to any particular account.

The following guidelines should be followed by examiners in reviewing investments in covered call options: (1) Sufficient authority must exist to make such investments and be evidenced by specific authority in the governing instrument, specific and express authority in applicable state law, prior written and binding consent from all beneficiaries, or court order from a court of competent jurisdiction; (2) Such an investment must be considered prudent for each trust account involved, coupled with a determination that employment of option writing as an investment strategy is consistent with the needs and investment objectives of the account; (3) Call options should be written only against shares of stock owned by the trust account; (4) Any options involved in such a program should be listed on a recognized options exchange; and (5) The trust department should have the necessary technical expertise to monitor and execute such transactions, which should be documented in accordance with approved policy by appropriate records, reviews and approvals.

Interest Rate Futures Contracts, Forward Contracts and Standby Contract - On March 12, 1980, the Board of Directors of the Federal Deposit Insurance Corporation issued a policy statement relating to insured State nonmember bank participation in the futures and forward contract markets to purchase and sell U.S. Government and agency securities. The statement is applicable to commercial and mutual savings banks and the Board has reserved the right to issue an additional statement of policy applicable to trust department activities of State nonmember banks at a later time.

The underlying security involved in these activities is often the Government National Mortgage Association (GNMA) pass-through, mortgage-backed certificate, however, other government-issued securities may be involved in certain of these transactions. The quality of the underlying security is not questioned, rather, it is the speculative transaction for other than investment purposes that can involve significant risk.

The GNMA guarantees timely payment of principal and interest of its pass-through, mortgage-backed certificates. The guarantees are backed by the full faith and credit of the U.S. Government. A GNMA pass-through certificate originates when a mortgage banker (issuer) assembles a pool of FHA and VA-guaranteed mortgages. When the pool is completed, the issuer submits to GNMA all documents needed for final approval of the issuance, GNMA indicates approval by signing the guarantee agreement and instructs the co-transfer agent to actually deliver the certificates to the issuer. Pass-through certificates have stated maturities equal to those of the underlying mortgages which range from 12 to 40 years. On the 15th day of each month, the security holder receives the monthly payment as determined by the amortization schedule of the pool plus a proportionate share of any prepayments. Due to prepayments, the average life of the security is estimated to be 12 years. Each pool is assigned a specific GNMA number and is traded by this number. Ownership of the security is registered. Each pool has a fixed rate of interest established at the time of issuance and, while delivery of the pool is effected by the assigned specific GNMA number, trading is conducted on a yield basis. Pricing of pools after the initial purchase by an investor is quoted on a yield basis related to prevailing market rates of interest compared to the established rate for the specific pool being traded. Normally up to 120 days may elapse between the time the mortgage banker assembles a pool of mortgages and the issuance of the pass-through, mortgage-backed certificates. To eliminate the risk of interest rate fluctuation during this period the mortgage banker enters into a contractual commitment to sell anticipated but uninsured certificates at a price assuring a profit.

Futures contracts are standardized contracts traded on organized exchanges to purchase or sell a specified security on a future date at a specified price. Very few futures contracts ever culminate in delivery of securities. The futures markets are designed primarily to be risk-transfer (hedge) markets rather than actual delivery markets.

Forward contracts are over-the-counter contracts

for forward placement or delayed delivery of securities in which one party agrees to purchase and another to sell a specified security at a stated price for future delivery. Contracts indicating settlement in excess of 30 days following trade date are considered to be forward contracts. Forward contracts are not traded on organized exchanges, generally have no requited margin payments, and can only be terminated by agreement of both parties.

Standby contracts are optional delivery forward contracts and are not currently traded on organized exchanges. The buyer of a standby contract (put option) upon paying a fee, acquires the right to sell securities to another party at a stated price at a future time. The seller (issuer) of the standby receives the fee and must stand ready to buy the securities at the other party's option.

Prior to engaging in these transactions for its trust accounts, the bank should determine that use of these contracts is legally permissible and appropriate as investment vehicles for the particular accounts, and that the bank's board of directors or its designee has established written policies and procedures which should be reviewed annually. As in the case of options, these policies should address adequate recordkeeping systems, dollar volume limitations regarding individual accounts, and appropriate controls and activity reports. The FDIC policy statement on this subject should prove a useful guideline for the examiner. Accountings and reviews should reflect a department's standardized valuation policy.

Examiners should bring to senior management's attention and comment upon in the report of examination any deficiencies in the department's policies and/or any departures from the above guidelines.

Money Market Funds - Cash Management - Various money market funds are offered for the short-term investment of small sums of cash. These funds are mutual funds and have differing portfolios depending on the particular fund. Investments in time deposits of financial institutions, commercial paper, and short-term U.S. Government or agency obligations are some of the more typical portfolio components.

Although the trustee may have full investment discretion it should be satisfied that the investment of trust funds in money market funds is appropriate. Where a doubt exists, sufficient authority should be sought in state statutes or court decisions, language of the accounts governing instrument, or by obtaining binding consents from all beneficiaries or written instructions from parties authorized to direct investment selection before utilizing these funds as investment media.

Money market funds are regulated by the Securities and Exchange Commission and are required to be audited. Prior to investing in a money market fund, the prospectus of the fund and portfolio should be reviewed to determine that the fund meets the objectives of the trust accounts. Thereafter, the fund should be reviewed periodically to ensure it continues to meet those investment objectives.

Money market funds generally accrue interest daily and pay interest at the end of the month. Many trust departments now have services which automatically invest available cash exceeding predetermined dollar limits in a money market fund. These are commonly called "sweep" arrangements.

The Comptroller of the Currency has placed a 10% limitation on money market funds for those common trust funds subject to that investment limitation. In other words, a money market fund investment may not exceed 10% of the market value of the common trust fund. However, the Department of Labor has recently opined that 100% of an employee benefit account could be invested in money market funds without violating the diversification requirements of ERISA. Of course, other considerations would have to be resolved before a money market fund is found acceptable.

During examinations of trust departments, the examiner should determine that money market funds have been properly analyzed prior to investment and that the funds are periodically reviewed. Appropriate comments should be included in the report of examination if such funds have not been properly analyzed or such investments are found to be inappropriate for the accounts involved.

Worthless Securities - On occasion the trust department will receive, particularly in decedents' estates and guardianship accounts, securities which are or have become worthless. As a segment of the research conducted to ascertain the value or lack thereof of such securities, the department should obtain documentation from the corporation commission or secretary of state, of the state in which the corporation was chartered, evidencing that the corporation is no longer in business. Frequently, this documentation will state that the securities are worthless. Once such a determination has been made, the information should be presented to the trust committee with a request for approval to charge-off any carrying value and identify the securities as worthless on department records.

Whenever possible, worthless securities should be returned to the trustor or account beneficiary. Those securities remaining in the bank's control may be left in the owning account or set up in a house "suspense" account and referenced to the owning account. For control purposes, it is recommended the department continue to carry the securities on the books at a nominal value.

A complete list of worthless securities should be maintained and the securities kept in the trust securities vault under dual control. Periodically the list should be reviewed to determine if any of the issues have become marketable, since they occasionally regain value. Protective measures are recommended to guard against neglect or misappropriation of the few securities that regain value.

<u>Tangible Assets</u> - Tangible investments include works of art, antiques, stamps, coins and bullion, and diamonds and gemstones. Such assets often appeal to individuals who do not need current income from all their investments and therefore can allocate a portion to tangibles in an effort to provide long-term capital gains with no current income tax consequences. Assets of this type are often viewed as an inflation hedge.

Am examiner has several objectives in reviewing the administration of tangibles. Firstly, the examiner needs to determine that the department has adequate control over the assets and has made provisions for proper storage and insurance. Rare stamps and coins should be submitted to an expert for authentication such as the Philatelic Foundation of New York (for stamps) and American Numismatic Association (for coins). For diamonds and other gemstones a certificate should always be obtained. It is essential that such assets be maintained under dual control. Consideration should also be given to separate storage of tangibles such as stamps, which can be significantly damaged by bending or fingerprints.

Accounts holding tangible assets should have appropriate provisions in the governing instruments permitting their purchase and retention. Management should be familiar with the requirements for proper storage of the tangible assets under its care and provide adequate insurance protection. Appraisals should be obtained periodically. With some notable exceptions, tangible investments may be difficult to liquidate. A national auction market does exist for investment grade stamps. Gemstones are usually sold by consignment through a major dealer. Some risks can be minimized by making such investments only in directed accounts and by using reliable dealers and auction houses.

The Economic Recovery Tax Act of 1981 essentially eliminated the option of investing in tangibles for self-directed employee benefit accounts (IRA, Keogh, Pension and Profit Sharing) after December 31, 1981. Under the law, any funds of a self-directed retirement plan used to purchase tangible assets must be treated as a taxable distribution of the plan's assets to the participant(s). However, if an independent trustee or qualified investment manager, vested with investment discretion, selected tangibles as an investment medium, the participants of the plan would not be similarly penalized.

C. DISCLOSURE OF BENEFICIAL INTEREST IN REGISTERED EQUITY SECURITIES

Section 13(d)(1) of the Securities Exchange Act of 1934 (Act) (refer to Prentice-Hall) generally requires that persons who acquire or hold more than a 5% beneficial interest in the outstanding equity security of a class registered pursuant to Section 12 of the Act, file a prescribed, informational acquisition statement. The beneficial ownership in excess of 5% of the registered, equity security of a nonbanking company would be filed in accordance with provisions contained in Sections 13(d)(1) through 13(d)(6) of the Act. (Beneficial interest consists of any vestige of investment discretion and/or voting power, regardless if either is actually exercised.)

Section 12(i) of the Act vests enforcement responsibilities of registered, equity securities of insured banks in the three respective Federal bank regulatory agencies. The Federal Deposit Insurance Corporation (Section 335.401 of its Rules and Regulations), the Comptroller of the Currency and the Federal Reserve Board have formulated and adopted similar requirements for the filing of acquisition statements. These statements prescribe that any person who, after acquiring directly or indirectly the beneficial interest of any equity security of a bank of a class which is registered under Section 12 of the Act shall, within 10 days after such acquisition, send to the bank at its principal office, by registered or certified mail, and to each exchange where the security is traded (if applicable) and file with the appropriate bank regulatory agency, a statement containing the information required by Form F-11 or F-11A. Although vested with enforcement responsibilities, the Federal Home Loan Bank Board has not codified regulations in accordance with Section 12(i) of the Act, therefore, required acquisitional statements regarding registered, equity securities of savings and loans should be filed in accordance with Section 13(d)(1) of the Act.

FDIC insured bank trust departments holding a beneficial interest exceeding 5% of a nonbank, registered, equity security should file the required acquisition statement with the Securities and Exchange Commission. Bank holding companies, including parent companies, are considered nonbank companies.

It is important to note that the 5% threshold may be achieved by the bank in its fiduciary capacity (as opposed to actual ownership) if it possesses any vestige of discretionary investment power or voting power. It is not germane that either of these powers is actually used or that they are delegated to another interested party. If the bank as fiduciary could exercise either of these powers and has such powers over an aggregate exceeding 5% of a registered, equity security, it would be necessary to file the acquisition statements.

D. SECURITIES TRADING

Trust department investment policies and procedures should preclude research analysts, traders and/or portfolio managers from trading for their own account under the auspices of the trust department. Appropriate checks should be made during the examination to ensure that the trust department's accounts with brokerage firms are utilized only to effect transactions for trust accounts or approved outside clients. If the bank has not established policies or control procedures, the examiner should discuss the potential hazards with management and recommend adoption of policies and procedures. The bank's audit program should include appropriate checks to compare confirmations and statements to department books to ascertain any misuse of brokerage accounts.

In general, borrowing for the purpose of investment is an improper activity for a trustee, except when purchasing improved real estate. The bank as fiduciary should not maintain a margin account with a broker unless specifically authorized by the terms of the governing instrument and directed by a party having appropriate authority.

Examiners should be alert for any involvement by trust accounts in speculative securities trading activities. Any speculative transaction ordinarily evidences contravention of "prudent man" doctrines and should warrant comment in the report of examination. The use of futures, forward and standby commitments is a speculative activity discussed earlier in this Section.

"Churning" is a term for excessive trading in an account for the purpose of generating commissions. In determining whether churning has occurred, consideration should be given to the following; number and frequency of trades, amount of "in-and-out" trading, amount of commissions generated; investor's objectives and level of business sophistication; and degree of control the broker has over the account.

Applicable Regulations (Part 344) - Part 344 of the Federal Deposit Insurance Corporation's Rules and Regulations governs the recordkeeping and confirmation requirements for insured State nonmember banks that execute securities transactions for their customers. Customer as defined in Section 344.2(b) includes any agency, trust, estate, guardianship, committee or other fiduciary account for which a bank effects or participates in effecting the purchase or sale of securities. The regulation therefore applies to trust department activities as well as commercial activities.

The purpose of Part 344 is to ensure that purchasers of securities are provided adequate information concerning a transaction and adequate records and controls are maintained with respect to securities transactions. Appropriate checks should be made during the examination to determine if the bank is in compliance. The trust department must follow minimum guidelines in complying with the recordkeeping and confirmation requirements.

(1) The bank must provide customers with information regarding securities transactions effected for their accounts within five business days of the date of the transaction by either of the following types of notification, unless acceptable alternate procedures as described in Section 344.5 have been elected: (a) A copy of the confirmation of the broker/dealer and a statement of the source and amount of any remuneration to be received by the bank; and (b) Written notification disclosing the name of the bank, name of be customer, date and time of execution (or the fact that the time of execution will be furnished within a reasonable time upon request), description, price and number of shares of securities purchased/sold, source and amount of any remuneration received in connection with the transaction, and name of broker/dealer used or name of person from whom securities were purchased/sold.

(2) Banks effecting securities transactions for customers must maintain the following records of those transactions for at least three years: (a) An itemized daily record of all purchases and sale of securities which includes the account, description of the securities, unit and total purchase or sale price, the trade date and name of broker/dealer or person from whom sold or purchased; (b) Account records for each customer reflecting all purchases and sales of securities and all receipts and disbursements of cash; (c) A separate memorandum (order ticket) for each order to purchase or sell securities (whether executed or cancelled) which includes: (1) the account name(s), (2) whether the transactions were a market order, limit order, or subject to special instructions, (3) the time the order was received by the person responsible for effecting the transaction, (4) the time the order was placed with the broker/dealer, or if there was no broker/dealer, the time the order was executed or cancelled, (5) the price at which the order was executed, and (6) the broker/dealer utilized; and (d) A record of all broker/dealers selected by the bank and the amount of commissions paid or allocated to each broker during the calendar year.

(3) The bank is required to establish written policies and procedures governing: The supervision of traders or others who transmit orders or execute transactions in securities for customers; Fair and equitable allocation of securities and prices to accounts when orders for the same security are received at approximately the same time; The crossing of buy and sell orders on a fair and equitable basis where applicable and permitted under local law; and Required reports from bank officers and employees who make or participate in the making of investment recommendations or decisions for the accounts of customers or who obtain information concerning which securities are being purchased or sold. The bank's policies must require officers and employees in these categories to report to the bank, within ten days after the end of each calendar quarter, all securities transactions made by them or in their behalf (excluding transactions in mutual fund shares, U.S. Government or Federal agency obligations and all transactions in the aggregate of $10M or less) during the calendar quarter.

Requirements of Part 344, relating to some aspects of recordkeeping and the necessity for written security trading policies and procedures, do not apply to banks executing fewer than 200 security transactions per calendar year for customers over the prior three calendar year periods, exclusive of transactions in U.S. Government and agency obligations.

<u>Soft Dollar/Broker Relations</u> - Section 28(e) was added to the Securities Exchange Act of 1934 by the Securities Acts Amendments of 1975. This section provides "safe harbor" protection to the fiduciary exercising investment discretion, provided certain conditions are met. Under Section 28(e)(1), "No person ... shall be deemed to have acted unlawfully or to have breached a fiduciary duty ... solely by reason of his having caused the account to pay ... an amount of commission ... in excess of the amount of commission another ... dealer would have charged ... if such person determined in good faith that such amount of commission; Has reasonable in relation to the value of the brokerage and research services provided ... in terms of either that particular transaction or his overall

responsibilities with respect to the accounts as to which he exercises investment discretion." Section 28(e)(3) defines brokerage and research services.

The "good faith" determination is a requisite for "safe harbor" protection. The general fiduciary duty to seek "best execution" is well established. Best execution implies the best net price to the customer, not necessarily the lowest commission rate. In general, the fiduciary is under the obligation to exercise diligence in seeking the best execution possible considering the following factors (as applicable); size of the order, trading characteristics of the security, availability of accurate price information for the most favorable market in which execution might be sought, and costs and difficulties associated with achieving execution in a particular market. Obviously, a trade involving 10,000 shares of a thinly traded security has characteristics not associated with a trade involving 100 shares of a "blue chip" security.

The term "soft dollars" refers to brokerage commissions. In a soft dollar arrangement, the commission paid to the broker also covers products and services, such as investment research, provided to the fiduciary by the broker in addition to the simple execution of a security transaction. The limited safe harbor provisions afforded by Section 28(e) can apply to the payment of commission dollars for computer software, if such constitutes "research or brokerage services" within the meaning as expressed in Section 28(e)(3), and if the bank determines in good faith that the amount of the commission is reasonable in relation to the services provided.

In general, research includes materials which constitute lawful and appropriate assistance to the money manager in his investment decisions. However, the Securities and Exchange Commission (SEC) has stated that safe harbor protection does not extend to services readily and customarily available to the general public on a commercial basis, nor to various computer software services sometimes distributed to financial institutions to assist in such administrative procedures as bookkeeping, recordkeeping and portfolio evaluation for purposes other than money management. The SEC has also stated that safe harbor protection does not extend to "give-ups" wherein one broker is directed to give up a portion of his commission to another broker. It is necessary that the research be provided by the broker in order to satisfy the requirements of Section 28(e), however, it is not necessary that the research services be produced "in house". Although a broker may, under certain circumstances, arrange to have research services produced by a third party, it is not "providing" such research services when it pays obligations incurred by the money manager to a third party. Section 28(e) does not apply to commission-splitting arrangements between brokers, wherein the first broker provides only research and does not maintain any normal correspondent relationship with the second (executing) broker.

Banks should not pay with soft dollars for services which are not properly classified as "brokerage" or "research" by such means as the prearranged, exclusive use of one brokerage firm. Neither should a bank contract or agree to provide a certain dollar amount or percentage of its brokerage business to a firm in payment for those services.

If a bank purchases products or services through brokerage commissions (soft dollars) arising from securities transactions for trust accounts, the bank must; (1) Avail itself of the protections of the "safe harbor" provisions of Section 28(e) consistent with all the requirements, or (2) Make accurate and complete disclosure of the bank's related policies and practices to prospective trust customers and, with respect to an existing account generating brokerage, to the person with rights of termination or the vested beneficiaries of an irrevocable trust and obtain such person's consent.

Soft dollar arrangements which do not conform could involve violations of law including the anti-fraud provisions of Federal securities laws and, in the case of an employee benefit plan, the "exclusive purpose" provision of the Employee Retirement Income Security Act of 1974 (ERISA). Bank management should be informed of such violations. The SEC may take enforcement action to enjoin continuation of such practices.

The Justice Department has long viewed the allocation of brokerage fees by banks based upon demand deposits of security dealers as reciprocity in violation of the anti-trust laws. Reciprocity means use by a company of its power as the

buyer of products or services to influence the sale of its own products or services. As part of the examination, the examiner should develop information on the type, amount and reasonableness of deposit accounts maintained by brokerage firms and used for trading.

Section 28(e)(2) states "A person exercising investment discretion . . . shall make such disclosure of his policies and practices with respect to commissions that will be paid . . . at such times and in such manner, as the appropriate regulatory agency, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors." To date, the Corporation has not mandated the disclosure of brokerage policies and practices under its Section 28(e)(2) authority. However, the trust examination should include a determination as to whether or not the bank is complying with its fiduciary duties in the placement of brokerage business.

E. EXAMINATION PROCEDURES

The Uniform Interagency Trust Rating System outlines the basic coverage the examiner should follow in evaluating investments. Examination coverage of investments encompasses a review of the bank's policies, practices and procedures relating to the selection, retention and preservation of assets including the methods used to review, protect and make productive the various types of assets comprising the trust department's aggregate portfolio. Examination objectives for trust investments include consideration of the following: (1) Adequacy of the investment selection and retention process including provision for committee approval and extent of compliance therewith; (2) Availability of an approved list of investments and system of approval of deviations therefrom; (3) Sources and quality of advice and research and adequacy of documentation to support investment and decision making; (4) The quality of administration accorded collective investment funds, master notes, real estate, mortgage loans, closely held corporations, mineral interests and other assets requiring special expertise; and (5) The general quality of investments and the sufficiency of supporting documentation. Where necessary the examiner should recommend changes in bank policies, practices and/or controls governing the acquisition, retention and disposition of investments.

The examiner's review of trust investments should go beyond verification of investment authorization, approvals and trade execution. Consideration should be given to the procedures used in determining securities to be included on recommended lists, documentation maintained in research files, and procedures followed in presenting recommendations to the board or trust investment committee. Minutes of the trust in vestment committee, or trust committee if there is no separate investment committee, should be reviewed to determine whether or not the minutes include complete documentation of all approvals. Investment reviews should also be recorded in the minutes and appropriate checks made to ascertain that account reviews are being properly conducted.

The allocation of fiduciary business to brokerage firms should be checked and adherence to investment procedures determined. Soft dollar activities should be reviewed to determine compliance with securities laws. Appropriate checks should be made to determine that department personnel are not trading for their own accounts.

Many aspects of the examiner's review may be covered by selecting a judgmental sampling of accounts and investments. When determining the volume of sampling to be undertaken, the examiner should consider: (1) The extent of such activity included in the scope of audits; (2) The comprehensiveness of master docket files, or synoptic records, which detail investment objectives and applicable restrictions pertaining to an account; (3) The quality of investment policies and capabilities of investment personnel; (4) The comprehensiveness of committee minutes relating to investment matters; and (5) The department's record of litigation or complaints arising from investment performance. By reviewing this sample, the examiner may determine conformity to the investment provisions of governing instruments and/or local law, purchase or retention of speculative or nonproductive investments, failure to diversify, adequacy of supporting documentation, and the department's expertise in handling special or unusual investments.